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EXAMINATION OF TAX-EXEMPT ORGANIZATIONS

The mission of the Tax Exempt and Government Entities Division (TE/GE) of the Internal Revenue Service is: To provide Tax Exempt and Government Entities customers top quality service by helping them understand and comply with applicable tax laws and to protect the public interest by applying the tax law with integrity and fairness to all.

Organizational Background

As part of the overall modernization of the IRS, TE/GE became operational in December 1999. TE/GE is the successor organization to the former Employee Plans and Exempt Organizations (EP/EO) function, which was established in the mid-1970s to regulate with regard to employee plans and exempt organizations.

TE/GE focuses on the needs and tax law responsibilities of three distinct customer groups: Employee Plans, Exempt Organizations, and Government Entities. The Exempt Organizations (EO) division addresses the particular needs and issues relating to tax law and procedures governing the tax-exempt community, with emphasis on customer education and outreach, determinations and rulings, and examinations programs.

Because TE/GE customers are generally exempt from taxes, TE/GE – including EO – focuses on enhancing and encouraging compliance with the tax law, rather than collecting tax revenues. Thus, education and up-front compliance programs are vital to accomplishing the TE/GE mission. When a tax-exempt organization is examined, EO tries to resolve any deficiencies so the organization can correct past problems and move forward in a way that ensures its future activities accomplish exempt purposes.

A Profile of Exempt Organizations Customers

More than 1.5 million tax-exempt organizations, including about 350,000 churches or other religious organizations, control more than \$1.3 trillion in assets. Of these organizations, about 700,000 are exempt under Internal Revenue Code section 501(c)(3) – charities, philanthropic groups, colleges and universities, etc.

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About 125,000 are exempt under section 501(c)(4) as social welfare organizations.

EO Approach to Compliance

Two Major Exempt Organizations Compliance Programs. The IRS seeks to ensure compliance with the various requirements for tax exemption in the Internal Revenue Code through two primary compliance programs: the EO determination letter program and the EO examination program. In addition to these, EO will focus on enhanced communication and outreach and the establishment of voluntary compliance programs, as part of the overall reorganization of TE/GE.

Under **the EO determination letter program**, an EO customer applies for a ruling from the IRS as to its status as a tax-exempt organization. Approximately 200 EO field employees work in the determination letter program, which is centralized in Cincinnati. The determination letter program allows the IRS to perform an up-front compliance check of an organization and at the same time educate the customer as to its rights and responsibilities. The IRS receives more than 80,000 EO applications a year.

The EO examination program operates from six area offices throughout the country, aligned with the customer base. About 400 EO employees are dedicated to exempt organizations examinations. In 1999, the IRS examined about 9,000 returns.

Selection of Organizations for Examination

A key feature of the new TE/GE organization will be a greater consistency in the EO examination process. When initial organizational implementation is complete in April 2000, the authority to begin an examination will rest with career employees located in the six EO area offices:

- Los Angeles, in the Pacific Coast Area
- St. Paul, in the Central Mountain Area
- Chicago, in the Great Lakes Area
- Atlanta, in the Gulf Coast Area
- Baltimore, in the Mid-Atlantic Area

Brooklyn, in the Northeast Area

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Under this new structure, the employees responsible for examination selection report to an office director under the Director, Exempt Organizations Examinations, located in Dallas. The centralization of the examination selection process in Dallas is a cornerstone of the reorganization of TE/GE. The centralization will enhance consistency and accountability and allow for greater expertise to be built up in the examination selection staff.

Role of the Exempt Organizations Headquarters Office

The office of the Director, Exempt Organizations, located in Washington, has overall management responsibility, including program management, but does not initiate examinations. Program management is exercised by issuing an annual work plan containing, among other items, areas of emphasis for the year's examination program and the amount of time that field offices' exempt organization examinations program should spend on areas of emphasis.

For example, the Fiscal Year 2000 work plan calls for the field offices to spend at least 20% of examination time on large case audits under the Coordinated Examination Program, and 10-15% of examination time on gaming activities of exempt organizations. The work plan also calls for:

- work on customer outreach,
- taking specific nationwide samples, and
- developing local projects (that is, statistically valid samples of local exempt organizations on a given issue to verify whether compliance issues exist).

The work plan recognizes that the field will also work on general casework, including: claims for refund, cases involving emerging issues outlined in the work plan (for example, organizations involved in car donation activities), and cases arising from the referral to the IRS of "information items."

Treatment of Information Items Concerning Exempt Organizations

The IRS periodically receives information items about exempt organizations from various sources. An information item is any communication received from a source outside the IRS containing (or attaching) allegations of an organization's potential noncompliance with a tax law. Information items also include referrals of items from other parts of the IRS, including other parts of TE/GE. For

example, an application for exemption occasionally will result in a referral of an entity to a field office to consider whether a future examination is warranted.

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The IRS receives information items from various sources, including the general public, members of Congress and other governmental agencies. Sometimes the IRS receives multiple referrals of the same item from different sources. For example, concerned individuals frequently forward copies of newspaper articles about a particular organization. Members of Congress may also forward the same article, either because they themselves are concerned or because they received it from a constituent.

Required Procedures For Handling Information Items

The IRS follows specific procedures for handling information items. (These are contained in Chapter 2 of Internal Revenue Manual (IRM) at 7.5.1 and are currently being reviewed and revised as part of the IRS reorganization.) The most recent changes, in December 1998 and June 1999, were made to strengthen the assurance that TE/GE operates in an unbiased and appropriate manner and that its compliance program actions are not improperly influenced by outside intervention. Additional revisions to the information item portion of the IRM will be completed shortly.

Several IRS offices, including Headquarters, may receive information items. In every case, the receiving office forwards the items to the field office with jurisdiction over the particular entity for whatever action the field office deems appropriate. As noted before, when the organizational implementation of TE/GE is complete, the examination selection process will be centralized in Dallas.

IRS procedures require that the field office must act on information items promptly (within 90 days of receipt), and must make a determination of whether the item indicates examination potential, no potential or the need for more information.

Examination potential is determined by career employees, generally by classifiers who are experienced revenue agents. In some cases, they refer information items to a committee composed of managers and experienced agents. Information items in this category include: cases involving churches, or political or lobbying activity. As a safeguard to protect the public interest, the committee approach is also used when

members of Congress or the Executive Branch make allegations (rather than just forwarding information from constituents, the press or the public), and whenever the classifier believes the committee approach is desirable for reasons of fairness or equity. *Note:* Certain referrals from the Executive Branch are now proscribed under section 1105 of the IRS

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Restructuring and Reform Act of 1998 (Internal Revenue Code section 7217).

Under procedures to be implemented soon, whether the committee or an agent is evaluating the information item, a “reasonable belief” standard is used. This standard requires that the information item, considered fairly and in light of other reliable information, indicates that a violation of relevant tax law may have occurred, or appears likely to lead to the discovery of a violation upon examination.

Current procedures implemented in 1998 require that all information items must be retained, whether or not they result in an examination. There is also a requirement that there be documentation outlining the receipt of the information item and the rationale for its disposition.

Data on Number of Examinations Resulting from Information Items

While information items are an important source of leads for the IRS, examinations triggered by these items constitute only a small part of the workload. Closures of these exams make up less than 10 percent of all EO examination closures. This percentage includes all information items, including those from other parts of the IRS.

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